**DEPARTMENT OF STATE REVENUE**

02-20110342.LOF

**Letter of Findings: 02-20110342**
**Corporate Income Tax**
**For Tax Years 2007, 2008, and 2009**

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## ISSUE

**I. Corporate Income Tax – Indiana Qualified Research Expense Tax Credit.**

**Authority**: IC § 6-3-2-1(b); IC § 6-3-1-3.5(b); IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-5-1; I.R.C. § 41; Treas. Reg. § 1.41-2; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Stinson Estate v. United States, 214 F.3d 846 (7th Cir. 2000); United States v. McFerrin, 570 F.3d 672 (5th Cir. 2009); Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930); Fudim v Comm'r, T.C. Memo. 1994-235 (U.S. Tax Ct. 1994); United States v. McFerrin, 570 F.3d 672 (5th Cir. 2009); Union Carbide Corp. v. Comm'r, T.C. Memo 2009-50 (U.S. Tax Ct. 2009).

Taxpayers claim that the Indiana Department of Revenue erred in disallowing the Indiana qualified research expense tax credit on wages allocated to their employees who performed qualified services.

## STATEMENT OF FACTS

Taxpayer is a qualified Sub-Chapter S Corporation incorporated in Indiana. Taxpayer and its subsidiaries (collectively, "Taxpayers") manufacture and sell wall-covering products in Indiana and outside of Indiana. When Taxpayers filed their original 2007 and 2008 consolidated Indiana corporate income tax returns, they did not claim any Indiana research tax credits. In 2009, Taxpayers employed a consulting firm ("Consultant") to conduct a study determining whether they were eligible to claim certain Indiana research tax credits. Based on the Consultant's study, Taxpayers subsequently amended their 2007 and 2008 Indiana income tax returns and also filed their original 2009 Indiana income tax return, claiming that they were entitled to "Indiana qualified research expense tax credit" and "Indiana enterprise zone credit."

In 2010, upon receiving Taxpayers' filings, the Indiana Department of Revenue ("Department") conducted an audit for those years. During the audit, the Department determined that some of Taxpayers' documentation suggested that they conducted some "qualified research" which, if verified, could be eligible for Indiana research expense tax credit. However, the Department repeatedly requested source documentation required to support Taxpayers' claimed "wage allocation" – from 1 percent to 52 percent for approximately 300 employees – for the Indiana qualified research expense tax credit purposes. Taxpayers declined to provide that documentation. The Department's audit thus concluded that Taxpayers failed to substantiate their claim that they properly allocated wages paid/incurred in order to receive the full Indiana qualified research expense tax credit on the wages. As a result, based on the best information available at the time of the audit, the Department disallowed some wages for which Taxpayers had claimed/allocated to certain employees or group of employees. The Department also disallowed the tax credit based on a laboratory's expenses because the laboratory is outside of Indiana. As a result, the Department's audit disallowed Taxpayers' claimed Indiana research expense tax credit, in the amount of $14,829.09 for 2007 tax year, and, in the amount of $9,857.62 for 2008 tax year. For 2009 tax year, however, the Department granted Taxpayers Indiana research tax credit, in the total amount of $12,250.50, which was $5,304.71 more than Taxpayers initially claimed.

Taxpayers only protested the Department's disallowance of their claimed "wage allocation." Specifically, Taxpayers objected to the audit's disallowance, arguing that the Department erred in requesting Taxpayers' source documentation of their wage allocation and that they "are not required to substantiate by adequate records or by sufficient evidence corroborating [their] own statement of the amount of such expenses." An administrative hearing was conducted during which Taxpayers' representatives explained the basis for the protest. This Letter of Findings results. Additional facts will be provided as necessary.

**I. Corporate Income Tax – Indiana Qualified Research Expense Tax Credit.**

## DISCUSSION

The Department disallowed some of Taxpayers' claimed Indiana qualified research expense tax credit on wages allocated to certain employees or group(s) of employees for 2007 and 2008 because Taxpayers' documentation failed to substantiate that they properly allocated wages for the purposes of claiming Indiana qualified research tax credit. Taxpayers, to the contrary, argued that they properly allocated a percentage of wages paid/incurred as Indiana qualified research expenses. Taxpayers maintained that they are not required to provide specific source documentation to justify their wage allocation for the purposes of claiming Indiana qualified research tax credit pursuant to federal and Indiana statutes, regulations, and case law.

Indiana mandates that every person who is subject to a listed Indiana tax must keep books and records,

including all source documents, "so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records." IC § 6-8.1-5-4(a). "If the [D]epartment reasonably believes that a person has not reported the proper amount of tax due, the [D]epartment shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the [D]epartment." IC § 6-8.1-5-1(a). All tax assessments are prima facie evidence that the Department's assessment of tax is presumed correct; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Similar to deductions, exemptions, and exclusions, tax credits "are matters of legislative grace." Stinson Estate v. United States, 214 F.3d 846, 848 (7th Cir. 2000). The taxpayer who claims a tax credit against any tax is required to retain records necessary to substantiate a claimed credit. Where such a credit is claimed, "the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974). Citing Stinson Estate, the court in United States v. McFerrin summarized that "[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." United States v. McFerrin, 570 F.3d 672, 675 (5th Cir. 2009).

For income tax purposes, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-2-1(b); IC § 6-3-1-3.5(b). Indiana also provides certain tax credits which a taxpayer may claim to reduce its taxable income. One of the tax credits is the "Indiana qualified research expense tax credit" under IC § 6-3.1-4-1, in relevant part, states:

> As used in this chapter:
> "Base amount" means base amount (as defined in Section 41(c) of the Internal Revenue Code as in effect on January 1, 2001), **modified by considering only Indiana qualified research expenses and gross receipts attributable to Indiana** in the calculation of the taxpayer's:
> ...
> "Indiana qualified research expense" means qualified research expense that is **incurred for research conducted in Indiana**.
> "Qualified research expense" means qualified research expense (as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001).
> "Research expense tax credit" means a credit provided under this chapter against any tax otherwise due and payable under IC 6-3.
> "Taxpayer" means an individual, a corporation, a limited liability company, a limited liability partnership, a trust, or a partnership that has any tax liability under IC 6-3 (adjusted gross income tax). (**Emphasis added**).

IC § 6-3.1-4-4 provides:

> The provisions of Section 41 of the Internal Revenue Code as in effect on January 1, 2001, and the regulations promulgated in respect to those provisions and in effect on January 1, 2001, are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period.

"Qualified research" is defined in I.R.C. § 41(d), as follows:

> (1) In general.--The term "qualified research" means research--
> (A) with respect to which expenditures may be treated as expenses under section 174,
> (B) which is undertaken for the purpose of discovering information--
> (i) which is technological in nature, and
> (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
> (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3). Such term does not include any activity described in paragraph (4).
> (2) Tests to be applied separately to each business component.--For purposes of this subsection--
> (A) In general.--Paragraph (1) shall be applied separately with respect to each business component of the taxpayer.
> (B) Business component defined.--The term "business component" means any product, process, computer software, technique, formula, or invention which is to be--
> (i) held for sale, lease, or license, or
> (ii) used by the taxpayer in a trade or business of the taxpayer.
> (C) Special rule for production processes.--Any plant process, machinery, or technique for commercial production of a business component shall be treated as a separate business component (and not as part of the business component being produced).
> (3) Purposes for which research may qualify for credit.--For purposes of paragraph (1)(C)--
> (A) In general.--Research shall be treated as conducted for a purpose described in this paragraph if it relates to--
> (i) a new or improved function,

(ii) performance, or
(iii) reliability or quality.
(B) Certain purposes not qualified.--Research shall in no event be treated as conducted for a purpose described in this paragraph if it relates to style, taste, cosmetic, or seasonal design factors.
(4) Activities for which credit not allowed.--The term "qualified research" shall not include any of the following:
(A) Research after commercial production.--Any research conducted after the beginning of commercial production of the business component.
(B) Adaptation of existing business components.--Any research related to the adaptation of an existing business component to a particular customer's requirement or need.
(C) Duplication of existing business component.--Any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.
(D) Surveys, studies, etc.--Any--
(i) efficiency survey,
(ii) activity relating to management function or technique,
(iii) market research, testing, or development (including advertising or promotions),
(iv) routine data collection, or
(v) routine or ordinary testing or inspection for quality control.
(E) Computer software.--Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in--
(i) an activity which constitutes qualified research (determined with regard to this subparagraph), or
(ii) a production process with respect to which the requirements of paragraph (1) are met.
(F) Foreign research.--Any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.
(G) Social sciences, etc.--Any research in the social sciences, arts, or humanities.
(H) Funded research.--Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).
I.R.C. § 41(b) also provides that:
**Qualified research expenses**.--For purposes of this section--
(1) Qualified research expenses.--The term "qualified research expenses" **means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer**--
(A) **in-house research expenses**, and
(B) contract research expenses.
(2) **In-house research expenses**.--
(A) In general.--The term "in-house research expenses" means--
(i) **any wages paid or incurred to an employee for qualified services performed by such employee,**
(ii) any amount paid or incurred for supplies used in the conduct of qualified research, and
(iii) under regulations prescribed by the Secretary, any amount paid or incurred to another person for the right to use computers in the conduct of qualified research.
Clause (iii) shall not apply to any amount to the extent that the taxpayer (or any person with whom the taxpayer must aggregate expenditures under subsection (f)(1)) receives or accrues any amount from any other person for the right to use substantially identical personal property.
(B) **Qualified services**.--The term "**qualified services" means services consisting of**--
(i) **engaging in qualified research, or**
**(ii) engaging in the direct supervision or direct support of research activities which constitute qualified research**.
If substantially all of the services performed by an individual for the taxpayer during the taxable year consists of services meeting the requirements of clause (i) or (ii), the term "qualified services" means all of the services performed by such individual for the taxpayer during the taxable year.
(C) Supplies.--The term "supplies" means any tangible property other than-
(i) land or improvements to land, and
(ii) property of a character subject to the allowance for depreciation.
(D) Wages.--
(i) In general.--The term "wages" has the meaning given such term by section 3401(a).
(ii) Self-employed individuals and owner-employees.--In the case of an employee (within the meaning of section 401(c)(1)), the term "wages" includes the earned income (as defined in section 401(c)(2)) of such employee.

(iii) Exclusion for wages to which work opportunity credit applies.-The term "wages" shall not include any amount taken into account in determining the work opportunity credit under section 51(a). (**Emphasis added**).

Treas. Reg. § 1.41-2 further illustrates "qualified research expenses," in relevant part, that:

(a) Trade or business requirement--(1) In general. An in-house research expense of the taxpayer or a contract research expense of the taxpayer is a qualified research expense **only if the expense is paid or incurred by the taxpayer in carrying on a trade or business of the taxpayer**. The phrase "**in carrying on a trade or business" has the same meaning for purposes of section 41(b)(1) as it has for purposes of section 162**; thus, expenses paid or incurred in connection with a trade or business within the meaning of section 174(a) (relating to the deduction for research and experimental expenses) are not necessarily paid or incurred in carrying on a trade or business for purposes of section 41. **A research expense must relate to a particular trade or business being carried on by the taxpayer at the time the expense is paid or incurred in order to be a qualified research expense**. For purposes of section 41, a contract research expense of the taxpayer is not a qualified research expense if the product or result of the research is intended to be transferred to another in return for license or royalty payments and the taxpayer does not use the product of the research in the taxpayer's trade or business.

...

(c) **Qualified services**–

(1) Engaging in qualified research. The term "engaging in qualified research" as used in section 41(b)(2)(B) means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments).

(2) **Direct supervision. The term "direct supervision" as used in section 41(b)(2)(B) means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). "Direct supervision" does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist**.

(3) **Direct support. The term "direct support" as used in section 41(b)(2)(B) means services in the direct support of either**--

(i) **Persons engaging in actual conduct of qualified research, or**

(ii) **Persons who are directly supervising persons engaging in the actual conduct of qualified research.** For example, direct support of research includes the services of a secretary for typing reports describing laboratory results derived from qualified research, of a laboratory worker for cleaning equipment used in qualified research, of a clerk for compiling research data, and of a machinist for machining a part of an experimental model used in qualified research. Direct support of research activities does not include general administrative services, or other services only indirectly of benefit to research activities. For example, services of payroll personnel in preparing salary checks of laboratory scientists, of an accountant for accounting for research expenses, of a janitor for general cleaning of a research laboratory, or of officers engaged in supervising financial or personnel matters do not qualify as direct support of research. This is true whether general administrative personnel are part of the research department or in a separate department. Direct support does not include supervision. Supervisory services constitute "qualified services" only to the extent provided in paragraph (c)(2) of this section.

...

(d) **Wages paid for qualified services**--(1) In general. **Wages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee**. **If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense**. **In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of in-house research expense shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year**.

(2) "Substantially all." Notwithstanding paragraph (d)(1) of this section, if substantially all of the services performed by an employee for the taxpayer during the taxable year consist of services meeting the requirements of section 41(b)(2)(B) (i) or (ii), then the term "qualified services" means all of the services performed by the employee for the taxpayer during the taxable year. Services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute substantially all of the services performed by the employee during a taxable year only if the wages allocated (on the basis used for purposes of paragraph (d)(1) of this section) to services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute at least 80 percent of the wages paid to or incurred by the taxpayer for the employee during the taxable year. (**Emphasis added**).

Thus, if a taxpayer wishes to exempt certain "wages paid to or incurred for an employee" under the "qualified

research expense tax credit," the taxpayer must show that these wages constitute in-house research expenses; i.e., the wages were earned when the employee was performing qualified activities within a qualified research project. However, to claim the Indiana qualified research expense tax credit on wages incurred, the taxpayer must first demonstrate that its activities meet the statutory/regulatory requirements of "qualified research," as defined in I.R.C. 41(d), and that the "qualified research" activities were conducted in Indiana in carrying on a trade or business of the taxpayer. Second, following the statutory/regulatory requirements, the taxpayer may only include in-house research expenses and contract research expenses paid or incurred by the taxpayer when the taxpayer demonstrates that the research expenses were incurred in carrying on any qualified research activities in Indiana.

"In-house research expenses" include "wages paid or incurred to an employee for qualified services" performed in Indiana and amounts paid or incurred for "supplies used in the conduct of qualified research" in Indiana. Indiana adopts federal interpretations of "qualified services," which include (1) services rendered in performing qualified research; (2) direct supervision of qualified research activities; and/or (3) direct support of qualified research activities. IC § 6-3.1-4-4; Treas. Reg. § 1.41-2(c)(1), (2), (3). "'Direct supervision' means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments)." Treas. Reg. § 1.41-2(c)(2). "'Direct supervision' does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist." Id. "'Direct support' of qualified research activities includes services in the direct support of '(i) [p]ersons engaging in actual conduct of qualified research,' or '(ii) [p]ersons who are directly supervising persons engaging in the actual conduct of qualified research.'" Treas. Reg. § 1.41-2(c)(3). Additionally, "direct support of research includes the services of a secretary for typing reports describing laboratory results derived from qualified research, of a laboratory worker for cleaning equipment used in qualified research, and of a clerk for compiling research data, and of a machinist for machining a part of experimental model used in qualified research." Id. However, "[d]irect support of research activities does not include general administrative services, or other services, or other services only indirectly of benefit to research activities." Id. Furthermore, "[w]ages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee." Treas. Reg. § 1.41-2(d)(1). "If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense." Id. Thus, only when a taxpayer demonstrates that wages paid or incurred to employees for qualified services performed by its employees for Indianan qualified research, is the taxpayer entitled to the Indiana qualified research expense tax credit.

When the taxpayer demonstrates that it conducts Indiana qualified research and its employees perform "qualified services" for the Indiana qualified research, Indiana permits the taxpayer, "[i]n the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate," to determine the claimed tax credit on wages "by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year." Id.

In this instance, during the audit, the Department first found that Taxpayers incorrectly included numbers from a subsidiary outside of Indiana into their claimed tax credit. Taxpayers subsequently resubmitted their documentation, but the Department noted that Taxpayers simply removed the wrong entity's information from the original "recaps" without source documentation to support their recalculation. The Department acknowledged that Taxpayers' documentation suggested that "research was being conducted." Thus, the Department's audit determined that "[r]ather than deny the credit entirely audit has focused on the wage portion of the credit and some adjustments to correct numbers for Indiana entities versus non-Indiana research." Thus, based on the information available during the audit, the Department made the following adjustments:

> Using the list of employees, interview recaps, and the organizational chart, audit began making adjustments to the wage component of the research credit. Audit first makes two simple adjustments. First, audit adjusts a few percentages listed on the wage recaps to match the percentage shown on the interview recaps. Then audit eliminates, adjusts the percentage to zero, employees not listed on the interview recaps.
>
> The next area looked at was direct supervision of employees engaged in qualified research activities and direct support. With the aid of the organizational chart, interview recaps, and wage reports, audit removed some upper level managers from inclusion in the wage portion of the calculations. These individuals were not researchers conducting experiments, but rather upper level managers. Furthermore, these individuals were not the first line supervisors of the individuals conducting the research of the first line supervisor of support staff.
>
> What these individuals are is some of the highest paid employees of the companies.... The VP of manufacturing and Plant Managers were not hired to perform research or to act as front line supervisors of the individuals conducting research. These individuals primary task is to manage and ensure the profitable manufacture of the product being produced. While these individuals may attend meetings to discuss various activities that do qualify as research, these are not the individuals doing the experimentation or their front line

supervisor.

The last area of adjustment to the wages was to bring in line the number of employees that were actually involved in the qualified research projects. For job titles where there were significant numbers of employees performing the job, audit has reduced the number by half. Taxpayer listed all employees for each job title claiming they were all involved in the research. As there was no documentation to support that every employee for each of the job titles listed actually participated in the any trial runs, audit reduced the larger lists by allowing only half of the listed employees. Audit Summary, Explanation of Adjustments, p14.

At the administrative hearing, and subsequently after, Taxpayers stated that they did not want to specifically protest which employees or which group(s) of employees the Department's audit erroneously disallowed. Rather, Taxpayers raised a fundamental disagreement concerning "burden of proof" and asserted that "the Department's audit did so either arbitrarily, or without any basis, much less a sufficient basis for doing so." To support their protest, Taxpayers submitted a package which contained 346 pages (bates labeled TGI 0001-TGI 0346), including several versions of 2006-2008 R & D Study Questionnaires, Project List and Description Appendix, Wage Allocations, e-mail correspondence among Taxpayers' employees and correspondence with a patent attorney, as well as lists of Project Updates. Taxpayers maintained that "[they] are not required to substantiate by adequate records or by sufficient evidence corroborating [their] own statement of the amount of such expenses" pursuant to Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930). Referring to Fudim v Comm'r, T.C. Memo. 1994-235 (U.S. Tax Ct. 1994), United States v. McFerrin, 570 F.3d 672 (5th Cir. 2009), and Union Carbide Corp. v. Comm'r, T.C. Memo 2009-50 (U.S. Tax Ct. 2009), Taxpayers believe that "[a]lthough Congress legislatively overruled the Cohan doctrine for certain types of expenses (e.g., travel, meals & entertainment, and etc.), the doctrine is still applicable for other non-specifically excluded expenses." Taxpayers thus argued that the Department's audit erroneously disallowed their estimated "wage allocation, summarily chopping allocated wages in half or more in many instances."

As mentioned above, the taxpayer who claims a tax credit against any tax is required to retain records necessary to substantiate a claimed credit and must show a case, by sufficient evidence, which is clearly within the exact letter of the law. Taxpayers' reliance on the Cohan doctrine thus is misplaced. In Cohan, the taxpayer (petitioner), a theatrical manager and producer, appealed one of the Board of Tax Appeals determinations, which disallowed 100 percent of petitioner's claimed deductions on travel expenses. The Cohan court, ruling in favor of the petitioner on this issue, stated, in relevant part, that:

> In the production of his plays Cohan was obliged to be free-handed in entertaining actors, employees, and, as he naively adds, dramatic critics. He had also to travel much, at times with his attorney. These expenses amounted to substantial sums, but he kept no account and probably could not have done so. At the trial before the Board he estimated that he had spent eleven thousand dollars in this fashion during the first six months of 1921, twenty-two thousand dollars, between July first, 1921, and June thirtieth, 1922, and as much for his following fiscal year, fifty-five thousand dollars in all.
>
> The Board refused to allow him any part of this, on the ground that it was impossible to tell how much he had in fact spent, in the absence of any items or details. **The question is how far this refusal is justified, in view of the finding that he had spent much and that the sums were allowable expenses**. **Absolute certainty in such matters is usually impossible and is not necessary**; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. **But to allow nothing at all appears to us inconsistent with saying that something was spent**. True, we do not know how many trips Cohan made, nor how large his entertainments were; yet there was obviously some basis for computation, if necessary by drawing upon the Board's personal estimates of the minimum of such expenses. The amount may be trivial and unsatisfactory, but there was basis for some allowance, and it was wrong to refuse any, even though it were the traveling expenses of a single trip. It is not fatal that the result will inevitably be speculative; many important decisions must be such. We think that the Board was in error as to this and must reconsider the evidence. Cohan, 39 F.2d, 543-44. (**Emphasis added**).

Unlike the Board of Tax Appeals which allowed none of Mr. Cohan's claimed travel expenses, the Department's audit explained its adjustments in detail which employees or group(s) of employees were disallowed based on Taxpayers' documentation, including "the list of employees, interview recaps, and the organizational chart." Also, unlike Mr. Cohan who claimed deductions on his own travel expenses for his federal income filings and testifying at trial (presumably, under oath in court) regarding his personal knowledge on the matter, Taxpayers, in this instance, primarily relied on two vice presidents' conclusive interview statements to support approximately 300 individuals/employees' claims that they performed "qualified services" for Indiana qualified research purposes and that a certain percentage of wages paid were properly allocated for their "qualified services" for Indiana qualified research expense purpose.

As discussed above, only when a taxpayer demonstrates that (1) the claimed qualified research is conducted in Indiana, and (2) the employees who participated in the Indiana qualified research projects perform "qualified services," may the wages paid or incurred be considered as the Indiana qualified research expenses. Upon reviewing Taxpayers' documentation, Taxpayers failed to meet the above mentioned statutory/regulatory

requirements. First, IC § 6-3.1-4-1 permits Taxpayers to claim Indiana qualified research expense tax credit only to the extent the "research [was] conducted in Indiana." Taxpayers' documentation showed that Taxpayers conducted their "research projects" not only in Indiana but also outside of Indiana; their documentation failed to show which qualified research project(s) or which portion(s) of the qualified research projects were conducted in Indiana. Taxpayers' documentation showed they were preparing to file one research result with the US Patent & Trademark Office, but failed to demonstrate that the relevant research activities were conducted in Indiana. Rather, Taxpayers' documentation showed that a patent was assigned to an affiliate located outside of Indiana, and that all three individuals who were claimed as "inventors" for that patent were non-Indiana residents. In short, Taxpayers' documentation failed to demonstrate (1) which qualified research project(s) or which portion(s) of the qualified research project(s) were the qualified research project(s) conducted in Indiana and (2) the employees performed "qualified services" of the Indiana qualified research.

Also, Taxpayers may argue that their vice presidents had personal knowledge of every employee who participated in and performed the "qualified services" concerning the Indiana qualified research, and that their vice presidents properly allocated the wages paid to every employee who performed the qualified services of the Indiana qualified research projects; however, Taxpayers' documentation demonstrates otherwise.

Taxpayers' documentation contained three versions of a 2006-2008 R & D Study Questionnaires ("Study"), including two vice presidents' conclusive interview statements, but all three versions had fundamental errors, rendering the Study (regardless of which version) inconsistent and unreliable. Taxpayers primarily relied on two vice presidents' conclusive interview statements, without source documentation, to support approximately 300 individuals/employees' claims that they performed "qualified services" for Indiana qualified research and that a certain percentage of wages paid were properly allocated for their "qualified services" for Indiana qualified research expense purpose. In one version of the Study (bates labeled TGI 0035-TGI 0057 and TGI 0323-TGI 0345), the determination of "qualified research project" and percentage of wages allocation (1 percent to 52 percent) for approximately 300 employee-participants was based solely on interviews with two of Taxpayers' vice presidents, who apparently did not have personal knowledge of the facts. In another version of the Study (bates labeled TGI 0287-TGI 0309), some "interview" statements were removed without any explanations, which left only M who was the sole interviewee on behalf of employee-participants in the Study. Furthermore, the "Wage Allocations" section to all three versions of the Study showed that Taxpayers claimed the credit on wages paid to its employee, N, twice, for different and inconsistent percentage of wages paid to N. An excerpt is provided for illustration purposes, as follows:

| Name | Job Title | [Percent] | Description of Qualified Activities |
|---|---|---|---|
| [N] | Production Manager | 2006-**15** [percent]<br>2007-**20** [percent]<br>2008-**15** [percent] | [N] directly supervised the [Subsidiary] employees during test production runs undertaken to ensure the functionality and performance of the new formulations and production process met specifications. [N] also utilized his industry expertise to determine the optimal methodology for producing the new [items] with the Company's existing equipment. Specifically, [N] designed the process specifications for the new item's compounds.<br>[N] has gained significant industry experience throughout his tenure with the Company. |

Interviewee Name: [E] Interviewee Signature: [E/signed]

(**Emphasis added**).

The above "interview" statement concerning N's work appeared on the first page of the "Wage Allocations" (bates labeled TGI 0045, TGI 0297, and TGI 0333), claiming 15/20/15 percent for those three years. The same interview statement concerning N's work appeared again on page 16 of the same "Wage Allocations" (bates labeled TGI 0050, TGI 0302, and TGI 0338), for "5 percent" for those three years, as follows:

| Name | Job Title | [Percent] | Description of Qualified Activities |
|---|---|---|---|
| [N] | Production Manager | **5** [percent] | [N] directly supervised the [Subsidiary] employees during test production runs undertaken to ensure the functionality and performance of the new formulations and production process met specifications. [N] also utilized his industry expertise to determine the optimal methodology for producing the new [items] with the Company's existing equipment. Specifically, [N] designed the process specifications for the new item's compounds.<br>[N] has gained significant industry experience throughout his tenure with the Company. |

Interviewee Name: [E] Interviewee Signature: [E/signed]

(**Emphasis added**).

As discussed earlier, the Department is required to determine a taxpayer's unpaid tax based on the best

information available if the Department reasonably believes that the taxpayer has not reported the proper amount of tax due. Taxpayers argued that the audit's adjustments in general were unreasonable, "summarily chopping allocated wages in half or more." But, Taxpayers could not specifically demonstrate which portion of the audit's disallowance of which employees or group(s) of employees was unreasonable. Rather, Taxpayers asserted that they were entitled to Indiana research tax credit as claimed based on the Study, which was inconsistent and unreliable. Taxpayers' 346-page documentation failed to demonstrate that their research projects were Indiana qualified research and the wages were properly allocated to employees who participated in the Indiana qualified research. The audit's disallowance based on the best information available during the audit was therefore reasonable.

Accordingly, given the totality of circumstances, in the absence of other documentation, the Department is not able to agree that Taxpayers have met their burden of proof demonstrating that the Department erroneously disallowed some of Taxpayers' claimed Indiana qualified research credit which Taxpayers claimed paid to their employees who performed "qualified services" of the Indiana qualified research activities and that they were entitled to the Indiana qualified research credit on the wage allocations as claimed.

**FINDING**

Taxpayers' protest is respectfully denied.

*Posted: 04/25/2012 by Legislative Services Agency*
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